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Person To Contact:
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Telephone Number:

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Date:
August 28, 2008

Legend

Authority =
State =
City =
Developer =
Company =

Facility =

Bonds =

Dear :

This is in response to your request for a private letter ruling that the sale of the Facility will not cause the Bonds to no longer be tax-exempt enterprise zone facility bonds under §§ 103 and 1394 of the Internal Revenue Code (the "Code").

Authority was created under State law to promote economic growth and employment in City. It has the authority to issue bonds to finance capital needs of the City's businesses and institutions.

The Facility is part of a large hotel, residential, and commercial space located within the City empowerment zone (the "Zone"). It is anticipated that the Facility will create both temporary and permanent jobs within the Zone.

Authority plans to issue the Bonds and loan the proceeds to Company who will be responsible for the actual construction of the Facility. Authority represents that the

Bonds will be tax-exempt enterprise zone facility bonds when they are issued. After construction is completed, either Company's interest in the Facility or Developer's majority interest in Company may be sold to a buyer who will operate the Facility as an enterprise zone business within the meaning of § 1397C. Developer is a joint venture between two members, one of whom is affiliated with companies that develop, acquire, and manage a diverse portfolio of properties throughout the United States.

LAW AND ANALYSIS

Section 103(a) provides that except as provided in subsection (b) gross income does not include interest on any state or local bond. Section 103(b)(1) provides that § 103(a) does not apply to any private activity bond which is not a qualified bond (within the meaning of § 141).

Section 141(a) defines a private activity bond as any bond that meets the private business test of paragraph (1) of § 141(b) and the private security or payment test of paragraph (2) of § 141(b), or which meets the private loan financing test of § 141(c).

Section 141(e) defines a qualified bond as any private activity bond if such bond is, among others, an exempt facility bond.

Under § 1394(a), an exempt facility bond described in § 141(e) bond includes any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to provide any enterprise zone facility. Section 1.1394-1(m) of the Income Tax Regulations provides that enterprise zone facility bonds are subject to the same rules and regulations as other exempt facility bonds other than as provided in § 1394. One exception under § 1394(d) permits the proceeds of enterprise zone facility bonds to be used to acquire land and existing property.

An enterprise zone facility is defined by § 1394(b)(1) as any qualified zone property the principal user of which is an enterprise zone business, and any land which is functionally related and subordinate to such property.

Qualified zone property is defined under § 1394(b)(2) by reference to § 1397D with some limited exceptions. Similarly, an enterprise zone business is defined under § 1394(b)(3) by reference to § 1397C with some modifications.

Section 1397D defines qualified zone property as any property to which § 168 applies (or would apply but for § 179) if (A) such property was acquired by the taxpayer by purchase (as defined in § 179(d)(2)) after the date on which the designation of the empowerment zone took effect, (B) the original use of the property in an empowerment zone commences with the taxpayer, and (C) substantially all of the use of the property is in an empowerment zone and is in the active conduct of a qualified business by the taxpayer in the zone.

In general, under § 1.1394-1(h), for purposes of issuing tax-exempt bonds under § 1394, the original use requirement of § 1397D is defined to mean the first use to which the property is put within the zone. For this purpose, use of property prior to a one-year period during which the property was vacant is disregarded. Prior de minimis incidental use is also disregarded.

Section 1.1394-1(p), Example 7, further clarifies the original use requirement for the purpose of bonds issued under § 1394. In the example, P uses bond proceeds after the zone designation to purchase property outside the zone and places it in service within the zone. All of the use of the property is in the zone in the active conduct of a qualified zone business by P. The property is treated as qualified zone property because P makes the first use of the property in the zone after the zone designation date.

Despite references in §§ 1397C and 1397D to “taxpayer”, § 1.1394-1 contemplates that the principal user of the bond-financed facility and the issuer will comply with the various requirements under § 1394 and those sections. For example, under § 1.1394-1(b)(3), there is deemed compliance if, in part, the issuer and principal user of the facility in good faith attempt to meet the requirements of § 1394(a) throughout the period of compliance. The period of compliance continues until the later of the end of the zone designation period or the weighted average maturity date of the bonds.

In general, § 1.1394-1(j) defines a principal user as the owner of the financed property. If the owner of real property financed with the bonds is not an enterprise zone business, but the rental of the property is a qualified business, the principal user means the lessee or lessees.

The tax incentives for enterprise zones, including enterprise zone facility bonds, are to be used to attract businesses and capital into areas with pervasive poverty, unemployment, and economic distress. H.R. Conf. Rep. No. 103-353, at 702 (1993). The first use provision under § 1.1394-1(h) for qualified zone property furthers this goal by precluding the use of tax-exempt bond proceeds to acquire property that already is in use in a zone (or was in use within the area designated as a zone at the time of the designation). Instead, issuers of the bonds may loan the proceeds to developers who buy the property outside the zone, or construct the property in the zone, and then use the purchased or constructed property in the zone. The issuer accomplishes the goal of accreting capital in the zone at the time the bonds are used for these purposes.

Congress recognized that over the long run, attracted capital must be used in an enterprise zone if the residents of the zone are to benefit from the tax incentives. Thus, qualified zone property must also be operated as a qualified zone business in the zone.

Whether or not the Bonds remain tax-exempt enterprise zone bonds after the sale of the Facility depends on whether or not the first use requirement is retested when the Facility is sold. If so, then the Facility would not have been first used in the Zone by the new owner and the Bonds would no longer be tax-exempt. For the reasons stated below, we do not believe that such a sale causes the Bonds to become taxable, or, in the words of the § 142 remedial action provisions, result in a change of use with respect to the Bonds if the Facility continues to be operated in the Zone as a qualified business.

First, regardless of the number of Facility owners, for purposes of § 1394, there is only one first use of the Facility in the Zone. It is this first use that is important because it implements the goal of bringing capital (*i.e.*, the Bond proceeds) into the Zone. The sale of the Facility does nothing to lessen this accomplishment.

Second, as the reason for the rule evidences, for purposes of § 1394, the first use rule relates to the first use of the property itself --not to the first use by a particular principal user. If the only qualified user of an enterprise zone facility were the person who constructs it or brings the facility into the zone, an enterprise zone business that wants to benefit from tax-exempt financing would have to commit to using the property for the entire compliance period. During that period, it is reasonably foreseeable that the property would be sold or leased. Indeed, § 1.1394-1(c) deems an issue of enterprise zone bonds to be in compliance if, in part, the issuer and the principal user in good faith attempt to meet the applicable requirements throughout the compliance period. The principal user, while generally the property owner, can be a lessee where the owner does not qualify. This rule ensures the on-going qualified use of the property and contemplates use by other than the original owner.

Third, the legislative history of § 1394 supports the conclusion that the change in use rules apply when enterprise zone facilities cease to be used by a qualified zone business—not when the facility is sold.

The conference agreement extends change-in-use rules to the qualified enterprise zone facility bonds. Accordingly, interest on all bond-financed loans to a business that no longer qualifies as an enterprise zone business or on loans to finance property that ceases to be used by the business in the empowerment zone or enterprise community, becomes nondeductible, effective from the first day of the taxable year in which the disqualification or cessation of use occurs.

H.R. Conf. Rep. No. 103-213, at 716 (1993).

CONCLUSION

Accordingly, for purposes of § 1394 only, we conclude that a sale of the Facility to a person who will operate the Facility as an enterprise zone business but who will not be the first-time user of the Facility in the Zone will not cause the Bonds to be other than

qualified enterprise zone facility bonds. We express no opinion about how the sale of the Facility would affect any other empowerment zone tax incentive available under the Code. Further, for purposes of any other empowerment zone tax incentive, no opinion is expressed or implied on whether the Facility is qualified zone property after its sale.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination

Sincerely,

Associate Chief Counsel
(Financial Institutions & Products)

By: _____
Timothy L. Jones
Senior Counsel, Branch 5

Cc: